31 July 2020

London Stock Exchange Group

London Stock Exchange Group response to FSB Guidance on financial resources to support CCP resolution and on the treatment of CCP equity in resolution

Introduction

The London Stock Exchange Group ("LSEG") is a financial market infrastructure provider, headquartered in London, with significant operations in Europe, North America and Asia. Its diversified global business focuses on capital formation, intellectual property and risk and balance sheet management. LSEG operates an open access model, offering choice and partnership to customers across all of its businesses.

LSEG operates multiple clearing houses. It has majority ownership of the multi-asset global CCP operator, LCH Group ("LCH"). LCH has legal subsidiaries in the UK (LCH Ltd) and France (LCH S.A.). It is a leading multi-asset class and international clearing house, serving major international exchanges and platforms as well as a range of OTC markets. It clears a broad range of asset classes, including securities, exchange-traded derivatives, commodities, foreign exchange derivatives, interest rate swaps, credit default swaps euro and sterling denominated bonds and repos.

In addition, LSEG operates Cassa di Compensazione e Garanzia S.p.A. ("CC&G"), the Italian clearing house, providing clearing services for a range of European securities as well as exchange traded equity and commodities derivatives.

I. General remarks

LSEG is a strong supporter of clearly defined Recovery and Resolution plans and continues to work alongside global and national regulators to ensure preservation of financial stability in the market. LSEG welcomes the opportunity to provide input to the 'FSB's Consultative Document on financial resources to support CCP resolution and the treatment of CCP equity in resolution' ("CD").

- We support the FSB's proposals to clearly identify possible default ("DF") and non-default ("NDF") scenarios in the tools and resources assessment. While doing so, it is important to ensure that Resolution Authorities ("RAs") have the ultimate say in conducting tools and resources assessments to strengthen financial stability both from a national and cross-border perspective while taking under consideration specific products and market participants served.
- We believe it is critical to ensure that prior to any triggering of Resolution, a CCP can make full use of its default waterfall and loss allocation tools according to its Rulebook. Indeed, during a default loss ("DL") scenario, the CCP's existing default waterfall is structured and assessed effectively to ensure that any resulting loss is fully allocated back to the CCP's membership and therefore avoids the need to put the CCP in resolution. The RA should not intervene until the recovery process is either (i) fully completed or (ii) deemed insufficient to ensure continuity of clearing services and guarantee financial stability.
- During a Non-Default Loss ("NDL") scenario, we support FSB's recommendations that the RA should distinguish between the different sources of a CCP's failure, including the different sources of operational problems that may occur, and adapt resolution tools and powers for each situation accordingly. Under NDL scenarios, we agree that CCP regulatory capital funded by shareholders remains the primary line of defence and has been calculated to respond to the probability and scale of risks in line with national regulations and in agreement with authorities.
- Concerning CCP equity, we believe that decapitalising a CCP, which is already at risk, can limit potential risk management options and impeded the CCP's ability to react to unprecedented market conditions. Any use of equity as part of the first set of tools during resolution could disincentivise market participants from participating in the default management and recovery process. Likewise, increasing CCP SITG to subsidise DL and designate SITG as a loss-absorbing tranche (as opposed to an incentive for the CCP to have strong risk management) would (i) negatively impact incentives, (ii) interfere with the RA's objectives, (iii) put a significantly depleted CCP in a worse condition and (iv) have detrimental effects on financial stability. The discussion on resolution of CCPs should clearly recognise the strong incentives structures currently in place to ensure CCP resilience.

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- Concerning the narrative around CCP shareholders' claims under No Creditor Worse Off Than in Liquidation ("NCWOL"), we would encourage the assessment of concrete cases of such NCWOL claims risks, based on specific legal analysis of the frameworks of the FSB's jurisdictions before providing any guidance on the issue. In all jurisdictions we operate in, shareholders are always served last by the insolvency administrator after all other claims have been satisfied. Therefore, we don't believe that CCP shareholders would be entitled to receive anything under the NCWOL. This is an important issue to analyse as often artificially linked to increased CCP resources in recovery.

You will find below detailed responses to the question raised in the CD.

II. Specific responses

Step 1: Scenarios

1. What are your views on the scenarios presented for evaluating existing tools and resources?

LSEG agrees with FSB's list of default and non-default scenarios as presented in the CD. We believe that DLs and NDLs should be approached separately when defining the CCP's resolution framework and the associated loss allocation mechanisms should reflect the respective responsibility structure.

Loss allocation mechanisms to address DLs such as initial margins, default fund, assessment powers, loss allocation methodologies such as Variation Margin Gains Haircut ("VMGH") and contract tear-ups ensure that any resulting loss is fully allocated according to the pre-agreed CCP rules and arrangements. Therefore, in the case of DLs, the only way a CCP can have an unallocated loss is if the RA intervenes and prevents the CCP from following its Rulebook. This option for the RA to intervene, must be based on a quantitative analysis on the potential impact that such decision could have on financial stability as well as taxpayers' money. Moreover, such action will likely lead to market claims under the NCWOL principle in some jurisdictions.

Regarding hypothetical DF scenarios, as described in the CD, whereby multiple CMs do not meet their obligations under the CCP's recovery actions, it must be noted that CMs are legally obligated to honour their contractual obligations under CCP's rules and arrangements. If a surviving member were to fail to meet its obligations to the CCP in a default scenario, then the CCP would be able to place it in default and fully allocate losses back among its surviving members and return to a matched book. CMs must ensure that they fulfil their obligations especially if the recovery plan has kicked in, as costs of fulfilling their obligations is significantly lower than the costs and disruption generated by more defaults. Therefore, it is not to the benefit of a CM to withhold payment and risk exposing itself to further costs.

Relevant authorities should monitor progress of the recovery plan and intervene only when they determine that maintaining CCP critical services will come at a cost to financial stability. This reinforces the need for cross-border enforceability of the resolution plan which should be a core part of the assessment.

Regarding NDL scenarios, we do believe that the list of NDLs in the CD is comprehensive and agree with the FSB that different types of NDLs should be treated differently under resolution plans. We would note however that, loss allocation from NDLs should reflect the level of responsibility and benefits perceived from a given service equally between CCP owners and CMs. As such, it is important to ensure that the Resolution plan considers contractual arrangements reflecting the respective responsibility structure: there is an argument to allocate some of the investment losses to the CCP's membership when the CMs have provided their consent on the investment policy.

Furthermore, just as in the case of DLs, we believe that it is very unlikely that a CM would not meet its contractual obligations as costs associated with non-compliance will be greater. Similarly, CCP's shareholders not supporting the CCP's recovery phase is another extremely remote scenario as they not only stand to lose their entire stake in resolution as the worth of the CCP would be close to zero, but also incur reputational damage which could be far more damaging in the medium to longer term.

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2. **Are there additional considerations that should be included in the guidance?**

We believe that the FSB's final guidance could include potential losses that are an indirect result of a CM's default, resulting from attempting to liquidate the defaulting CM's collateral to meet variation margin payments to non-defaulting CMs. We view that such risk should be addressed upfront (via the collateral acceptance policy or minimum cash requirements for e.g.) but could lead to similar issue (i.e. a liquidity shortfall) such as the failure of a custodian bank, settlement platform, payment bank or concentration bank.

For reference, LCH published in August 2016 a whitepaper on CCP recovery and resolution[1], which discusses the various default and non-default scenarios, the current defences in place to mitigate these risks, and what would happen if they were not sufficient.

LSEG would like to emphasise that the content of the resolution plan should be sufficiently granular, fully tailored to a particular CCP taking into account the specific market and participants it serves to be successfully implemented and the "triggers" for resolution clearly defined. We believe that the RA should not intervene before the recovery process is either fully completed or deemed insufficient (i.e. resources fully depleted) to ensure continuity of clearing services, maintain a transparent and predictable process for clearing members, and guarantee financial stability.

Step 2: Evaluating existing resources and tools

3. **Are the qualitative and quantitative considerations for evaluating existing resources and tools comprehensive and sufficiently clear?**

LSEG agrees with the list of qualitative considerations for evaluating existing resources and tools and we would like to thank the FSB for taking into consideration our comments to the 2017 Consultation Paper, particularly with regards to the different treatment of product cleared.

Regarding implications arising from CCP ownership structures, we believe that CCPs should be standalone entities that are adequately resourced to cope with both DL and NDL and the availability of loss absorption resources should not be impaired by a parent entity. Also, any legal impediments should be mitigated by ensuring that legal risks in all jurisdictions a CCP is operating in are fully addressed and all the CCP's rules and procedures can be enforced.

We are supportive of a clear qualitative analysis performed in close collaboration with the RA to identify resources available at each phase. LSEG's CCPs work very closely with regulators on a regular basis through supervisory stress testing for extreme market scenarios which can provide regulators with a realistic market response under an extreme market scenario. We would support further cross-border stress testing involving other major jurisdictions to strengthen financial stability. We believe that regulatory cooperation in times of extreme market conditions is of the utmost importance to address the situation in a timely manner.

Regarding available resources and replenishment of those to be used as tools for default loss scenarios, we agree that the list of points that RA should consider. Furthermore, we believe that similarly to most CCPs rules and procedures governing the allocation of default losses, RA's cash calls should be in addition to the CCP's cash calls so that they don't limit tools available to a CCP and there should be clarity as to the point in time that those additional cash calls can be called by the RA. Regarding the replenishment of resources, similarly to cash calls, granularity will be required as to the point in time that non-defaulting members must replenish and "triggers" for a replenishment order that would need to be communicated. In both cases clear liquidity thresholds should be pre-agreed to ensure compliance of CMs.

Regarding VMGH, it is important to note that, this tool is only applicable to the OTC and listed derivatives market and should only be used as a last resort (i.e. when losses cannot be managed using existing

[1] Recovery and Resolution a framework for CCPs, August 2016 https://www.lch.com/system/files?file=media_root/CCP%20Risk%20Management%20Recovery%20%26%20Resolution%20-%20An%20LCH.Clearnet%20White%20Paper.pdf

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funded and unfunded resources). In addition, this tool aims at allocating losses only to CMs that have cumulative net gains and at LSEG's CCPs the amount of VM that can be haircut is capped either using monetary or time thresholds following provisions included in the Rulebook. In terms of its impact to financial stability, the tool in principle aims at putting an end to potential cumulative losses by incentivising CMs to assist in returning the CCP to a matched book, or at least to flatten their most volatile positions at the CCP (e.g. by moving directional portfolios to another market).

Regarding full tear up, partial tear up or other position allocation/matched book tools, these should only be considered as a "last resort" and we believe that it is important for the RA to consult in a timely manner with major market participants before activating them. It will ensure that all stakeholders are well informed about the consequences and costs associated with the continuation of the service and can make their in-house determinations in advance. This will limit potential future claims.

A CCP's dedicated resources in the default waterfall (SITG) is a prefunded predefined tranche of capital ready to be deployed before CMs' default contributions should there be a need. LCH has implemented EMIR requirements regarding SITG which are the most stringent when compared to all major jurisdictions. As such we believe that the level of SITG is well-calibrated to (i) ensure that a robust risk management framework is in place to ensure effective management of risk assumed by CCPs and (ii) to ensure that the incentive structure is not impaired and that CMs in their capacity as risk takers would need to cover the majority of losses in a defaulting scenario. Therefore, we do not believe that further consideration on the level and/or the source of additional CCP resources should be conducted. The most recent ESMA stress test[2] demonstrated that even under a so-called "implausible" market turmoil such as the Covid-19 crisis, EU CCPs had confirmed their resilience to common shocks and multiple defaults. Furthermore, the results showed no evidence of systemic implication in the knock-on effect of from second round effects to non-defaulting members via the risk-sharing mechanism and that a combination of defaults would have a rather limited impact on other CCPs with the percentage consumption of prefunded resources being below 20%.

Finally, we support the need for the RAs to consider statutory powers when assessing CCPs' tools and resources. We believe that, authorities should consider including some of their resolution tools (such as cash calls in addition to the assessments included in the recovery plan) in the CCP rules and arrangements, to increase legal certainty for RAs and allow them to focus on promoting financial stability by employing the relevant resolution tools in unprecedented market conditions, without being inappropriately constrained by concerns around legal claims. This would also bring additional transparency for CMs, allowing them to measure their risks in resolution and have the right safeguards in place to be ready to respond to the measures defined in the resolution plan. This is, therefore, more likely to promote a successful resolution.

This would also allow striking the right balance between efficiency and the necessary need for transparency and predictability for market participants. LSEG would recommend setting out in the CCPs' Rulebooks as much details as possible on the resolution plans, including the potential losses that could arise from the use of the resolution tools.

Regarding NDLs, we broadly agree with the points that need to be taken under consideration by the RA when developing a resolution plan as listed in the CD. Furthermore, we note that the CCP's equity is the main loss allocation tool in respect to NDLs however, the loss allocation from NDLs should reflect the level of responsibility and benefits perceived from a given service equally between CCP owners and CMs. Again, similarly to the DLs, it is important to consider potential statutory powers the RA should have to strengthen their role in promoting financial stability.

4. Are there additional considerations that should be included in the evaluation

LSEG has no further comments to make in the evaluation of existing resources.

Step 3: Assessing resolution costs

[2] https://www.esma.europa.eu/file/56245/download?token=pxdY_-Yd, ESMA 3rd Stress Test, July 2020

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5. Are the considerations for analysing resolution costs comprehensive and sufficiently clear?

We generally agree with the list of considerations included in the CD for analysing resolution costs. We would note however that, losses due to the failure of custodian, depository or agent bank would not necessarily result in actual losses of CCP resources as such, however it may not be able to temporarily access them so more of a liquidity issue. Resources at custodian banks or depositories are held in a strictly insolvency remote manner to protect underlying assets.

6. Are there any other resolution costs that should be addressed?

LSEG has no further comments to make in the assessment of resolution costs.

Step 4: Identifying gaps

7. What are your views on the considerations for resolution authorities when they identify gaps in resources and tools?

We believe that a CCP's risk management framework is designed in a way that prevents the need for addressing funding gaps. We do agree however that, even in a situation where the RA is not able to identify a potential gap it should not preclude that such a gap could exist. This is mainly because CCP recovery (let alone resolution) frameworks aim to address unprecedented extreme cases with several defaults, extraordinary market moves and defaults spreading across CMs such that the prevention and resolution measures from their own regulatory regime and authorities' supervision has failed and that cooperation between banks' supervisory authorities did not allow addressing the issue before the CCP's dedicated resources are exposed to potential losses.

CCPs reflect the market they serve, especially in case of DLs, any event affecting them would necessarily reflect the broader state of the marketplace. CCPs handling major defaults would be the result of a much bigger problem in the financial system and would therefore require strong cooperation and involvement of Authorities on a cross-border basis, not only to ensure the management of the resolution of a CCP, but to manage the multiple resolutions at stake which led to the situation – including the resolution of defaulting CMs and ensuring that they continue to fulfil their obligations towards the CCP (and the broader clearing community) in line with the FSB's Guidance on Continuity of Access to Financial Market Infrastructures ("FMIs") for a Firm in Resolution[3].

CCPs resources for resolution, therefore, should not be considered in isolation i.e. if CMs are not subject to bail-in, then the CCP would have the absolute benefit of members' own recovery and resolution plan and resources prior to even reaching the start of the CCP default waterfall. LSEG believes that it is of paramount importance to ensure that members meet their obligations towards CCPs and work collaboratively with local regulators on a continuous basis to ensure that any issues can be addressed effectively from the very beginning.

8. Are there additional considerations that should be included in the guidance?

LSEG has not further comments to make on the identification of gaps in resources and tools.

9. Are there any specific steps or approaches you would suggest that authorities consider as part of quantitative analyses?

[3] Guidance on Continuity of Access to Financial Market Infrastructures (FMIs) for a Firm in Resolution, July 2017 http://www.fsb.org/2017/07/guidance-on-continuity-of-access-to-financial-market-infrastructures-fmis-for-a-firm-in-resolution-2/

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LSEG would highlight the importance of close collaboration between the RA and the CCP when conducting those quantitative analyses to ensure that the analysis captures all relevant market specific elements and that there is enough transparency in the process for all market participants.

Step 5: Evaluating means to address gaps

10. What are your views on the considerations for evaluating the availability, costs and benefits of potential means to address identified credit or liquidity gaps?

LSEG broadly agrees with the views and considerations for evaluating the availability, cost and benefits of potential means to address identified credit or liquidity gaps. We would suggest, however, the FSB to take the following aspects into consideration:

Resources available for the recovery phase as well as other loss allocation tools are constantly monitored to ensure that there are sufficient resources to address any extreme but plausible scenario and as such, we don't believe that there will be a gap that needs to be addressed. If all available resources in the recovery phase have been utilised, Resolution will be the only way to ensure continuity of critical services in a given market to maintain financial stability. Even under such extreme scenario though, a number of market defaults would have occurred prior that to the CCP's default which would need to be addressed first and in a timely manner.

We support the use of the RA's ability to call cash calls, in addition to CCP's cash calls, in an attempt to provide necessary resources in Resolution. In terms of the amount of RA cash calls, we believe that, size of cash calls should be proportionate to the members' contribution to the default fund and should be included in the CCP's Rulebook to provide transparency and predictability to clearing members as well as protect the RA against future claims (NCWOL).

Regarding write-downs/bail in powers as included in the CD, we agree with the FSB's suggestion to include possible write-downs.

We don't believe that IM write down should be available to RAs as any write-downs to IM to have negative impacts to the overall financial stability and their efforts to rescue a CCP. This view was also reflected in the recently agreed EU CCP Recovery and Resolution framework whereby all three co-legislators recognised systemic implications that such measure would have to financial stability particularly in a market stress scenario.

Concerning the narrative around CCP shareholders' claims under NCWOL, we would encourage the assessment of concrete cases of such NCWOL claims risks, based on specific legal analysis of the frameworks of the FSB jurisdictions before providing any guidance on the issue. In all jurisdictions we operate in, shareholders are always served last by the insolvency administrator after all other claims have been satisfied. Therefore, we don't believe that CCP shareholders would be entitled to receive anything under the NCWOL. This is an important issue to analyse as often artificially linked to increased CCP resources in recovery.

Regarding the interaction of additional financial resources with the Recovery and business as usual of a CCP, we agree the FSB that any additional resources should not change the incentive structure established at CCPs or weaken a CCP's recovery phase. On the contrary, we believe that more attention must be placed on CCP Resilience and Recovery to ensure that we as an industry never get to Resolution in the first place. It is also important to highlight that clearing members, who are the risk takers, must be incentivized enough to ensure that the Recovery phase runs smoothly as costs associated in Resolution would far outweigh any potential benefits. Finally, we would support increasing the scope of the NCWOL counterfactual (i.e. the alternative scenario to the intervention of the Resolution Authority resulting in the CCP's insolvency) to provide RAs with more flexibility while at the same time strengthen the Recovery phase thereby further removing the likelihood of bail-in funds being used in the first place.

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11. Are there additional suggestions for potential steps to address identified credit or liquidity gaps that should be included in the guidance?

LSEG has not further comments to make regarding credit or liquidity gaps.

Treatment of CCP equity in resolution

12. Are the considerations for addressing the treatment of CCP equity in resolution plans sufficiently clear?

LSEG broadly agrees with the considerations for addressing the treatment of CCP equity in resolution plans. As noted in previous responses, we believe that CCP equity is calibrated to align incentives between the CCP and its members and placed before the members default fund to further strengthen a CCP's commitment to the recovery phase.

Regarding equity bearing losses in resolution, we do not believe that decapitalising a CCP that is already at risk, most likely because of external events, will provide RAs with additional flexibility in Resolution. At that point in time, shareholders' equity will have been written off. Imposing further losses can limit potential options and ability to react to unprecedented market conditions. Due consideration should also be given to the impact that a CCP's equity write-off could have on other unaffected asset classes cleared by a CCP which maintains segregated pools of collateral per product to avoid propagating shocks through markets.

Finally, we agree with the FSB's considerations that, a resolution plan must ensure that it maintains the right incentives including on the clearing community to have strong default management processes and recovery tools. Any automatic use of equity as part of the first set of tools during resolution, could disincentivise market participants to participate in the default management and recovery processes. Likewise, it could put additional pressure on the CCP Resilience – CM should be incentivised to avoid recovery and resolution and therefore support a strong CCP Resilience framework, including Margins, collateral eligibility, members' eligibility criteria etc.

13. Are there additional factors that resolution authorities should consider when evaluating the exposure of CCP equity to losses in resolution?

LSEG has no further comments to make regarding exposure of CCP's equity to losses in resolution

14. Are there additional mechanisms that could be used for adjusting the exposure of CCP equity to losses in resolution that should be included in the guidance?

In line with our previous responses, we are of the view a CCP's SITG is well calibrated to align incentives between the CCP and its members and we don't believe that additional exposure of a CCP's equity in either recovery or resolution phase would be justified. It is important to highlight at this stage that CCPs are the risk managers and not the risk takers. They don't place any risk to the system but manage the risk brought by CMs who should also be liable to pay for any losses incurred from their trading activities. As entities which are ultimately responsible for risk management, CCP SITG should only contribute to losses that occur beyond the pre-funded resources of a defaulting member (in event of a member's default).

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Contrary to DL, the regulatory capital funded by the CCP's shareholders is the primary line of defence and has been calculated to respond to the probability and scale of risks stemming from NDL. EMIR[4] expressly imposes operational capital to address each specific kind of non-defaulting risk. This is reviewed by the relevant supervisory authorities. NDLs are therefore catered for in the definition of the CCP's capital itself and remain CCP's primary responsibility to cover any such losses.

When it comes to losses following a default, the existing initial margins, guaranteed fund, assessment powers, VMGH and ability to do contract tear ups, ensure that any resulting loss is fully allocated. These arrangements are regularly tested by CCPs, on a national level by regulators and in the international level by cross-border fire-drills involving multiple CCPs (e.g., CFTC fire drills[5] and ESMA EU-wide stress-tests[6]).

Therefore, in a default scenario, we believe that unallocated losses in the recovery phase could result only when a CCP is impeded from allocating DL according to its Rulebook in a predictable manner.

Exposure of some or all of the CCP equity to losses via modification of the contractual loss allocation arrangements

As rightly pointed out in the CD, when it comes to DL, a CCP's contribution is based on the concept of the CCP having SITG to align its incentives in risk management to those of its CMs. SITG is designed as a capital portion of the CCP and not as a tool to absorb losses in a default scenario. Whilst the intention behind the idea of increasing CCPs' SITG to reinforce incentives is clear, it is in fact problematic when it aims at creating a loss-absorbency layer for CMs' trades. SITG acts as an incentive for the CCP to maintain high resilience standards: with its own funds at risk immediately after the contributions of the defaulting clearing member, the CCP operator is incentivised to perform prudent risk management and operate margin policies that protect the resources of non-defaulting clearing members. This mechanism aligns CCP's interests with those of its stakeholders but is not designed to be a material component of loss absorption.

There is no need for CCPs to increase their SITG. In particular, SITG should not be relative to the size of the default fund or the overall CMs exposure. This would fundamentally change its purpose and the CCP's risk profile: CCPs should not guarantee the trading activities of their CMs:

- Impact on incentives: an increase of SITG would create a misalignment of CMs incentives, as members could see potential losses linked to their activities partially funded by the CCP. This would create moral hazard.
- Increase of systemic risk: It would fundamentally change the CCP's risk profile. CCPs are designed to manage risk, not to absorb DLs. Increasing SITG may actually weaken the CCP, as it brings forward the point of distress at exactly the time the CCP is most needed to address a stress scenario.
- Increase in clearing fees: CCPs would be forced to increase clearing fees in order to preserve acceptable returns to their shareholders. This would further constrain balance sheet capacity of financial institutions and buy-side firms and create impediments to clearing, in conflict with the original regulatory objective of addressing systemic risk through increasing clearing flow through CCPs.

This has been illustrated in a recent paper discussing the impacts on clearing fees associated with the increase of SITG[7]: In a typical CCP with minimum regulatory capital need, Kreg, and SITG of 25%. If the CCP is running a 20% notification buffer, then the total capital held by the CCP is 1.2*1.25*Kreg. Suppose further that the CCP cost of capital is 10% currently. If the CCP has a current return on capital of r%, then one can calculate the maximum amount of SITG it can afford as 12.5*r – 1 before breaching its cost of equity to the shareholders. This would not be enough to generate any meaningful loss absorbency for

[4] COMMISSION DELEGATED REGULATION (EU) No 152/2013 of 19 December 2012 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on capital requirements for central counterparties – Article 1 Capital requirements.

[5] Clearing Requirement Determination Under Section 2(h) of the CEA; Final Rule; December 13, 2012 https://www.cftc.gov/LawRegulation/FederalRegister/FinalRules/2012-29211.html

[6] https://www.esma.europa.eu/file/56245/download?token=pxdY_-Yd, ESMA 3rd Stress Test, July 2020

[7] Cf. Journal of Financial Markets Infrastructures 7(1), 47-55 – risk.net – Dennis McLaughlin 'Skin in the game'.

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member trading losses. The analysis also shows that there is not much scope for a CCP to carry "dead capital" before it would start returning less than the cost of equity and would discourage private capital from funding the CCP. Certainly, having to prefund an amount which creates a meaningful loss absorbency to excessive member losses would create this problem. In other words, mandating a CCP to capitalise its own resolution fund would conflict with the policy of having a private sector solution to address systemic risk, unless the CCP were to raise clearing fees substantially. Assuming that, the abovementioned CCP was to earn at least its cost of capital and increase SITG, a number of consequences would immediately follow:

- An increase in the current levels of SITG by anything greater than a factor of 4 would necessitate an increase in clearing costs.
- Members' clearing costs in this case would have to be increased by at least 50% if SITG were to increase by a factor of about 7.
- Members' clearing costs would need to be at least doubled if SITG were to be increased by a factor of about 10.

Therefore, we support the current CCP regulatory capital requirements (e.g., under EMIR). We fully agree that SITG is well calibrated and essential to align incentives, but it is not designed to be a material component of loss absorption. We consider that the EMIR standard (25% of regulatory capital) achieves the right incentives and should not be altered. In addition, the above case study clearly demonstrates that, if CCPs' SITG were to increase, CMs would effectively end up funding the solution. This would then have the knock-on impact on further constraining balance sheet capacity available to the buy-side, in conflict with the original regulatory goal of addressing systemic risk. Furthermore, additional exposures of a CCP's SITG would likely diminish the competitiveness of CCPs across jurisdictions where those requirements are currently not mandated resulting in increasing costs of clearing and putting additional strain on smaller CCPs.

Equity bearing losses in resolution

When it comes to alternative mechanisms for adjusting the exposure of CCP equity bearing loss in resolution, LSEG would encourage regulators to clearly distinguish between (i) operational capital requirements enabling a CCP to continue to operate and (ii) shareholders' losses in case of resolution due to a sudden dilution.

LSEG believes that, such distinction could be further clarified in the Guidelines. Moreover, provided that integrity of operational capital is a precondition to the business continuity of the CCP's critical services, we believe that, when addressing potential resolutory actions, RAs should always focus on maintaining the integrity of the operational capital. Exposing operational capital to losses would in fact interfere with the RA's objectives and result in putting a significantly depleted CCP in a worse condition.

We agree with the FSB's guidance that when evaluating the timing and sequencing of imposing losses on CCP equity the RA must consider financial stability implications. We believe that to achieve this, as a general rule, the RA should refrain from interfering with the CCP's recovery process unless the CCP breaches material obligations which could have an impact on financial stability, such as a failure to maintain the appropriate level of capital.

Nevertheless, at the point in time when the RA authority steps in, we believe that resources must be available to enable the RA to perform its duties. Automatically exposing CCP operational capital to losses, would interfere with the RA's objectives and result in putting a significantly depleted CCP in a worse condition than it was before:

- Using CCP operational resources to cover CMs market losses, which would theoretically have consumed the entirety of the CCP's default waterfall resources, would prevent the RA from fulfilling the main objective of resolution which is to return to a matched book. CCP regulatory capital is not designed to absorb trade losses of its members.
- A RA would be forced to find ways to replenish a CCP's operational capital in the middle of a market meltdown which would complicate further the implementation of the resolution process.

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- Placing the CCP in resolution following DLs, would likely to be due to exceptional circumstances, potentially several CMs not fulfilling their contractual arrangements toward the CCP and their own resolution authorities not being in a position to enforce these commitments, as suggested in the DP. Sanctioning the CCP by exposing the CCP equity or its shareholders to losses under these circumstances might therefore not be appropriate. The RA should approach these issues in resolution, on a case-by-case basis.

Shareholders are exposed to losses associated with operating the CCP (NDLs) and should not be exposed to losses generated from trading activities of members beyond those covered by CCP Rulebook powers. If this were to change, CCP shareholders would have an impact on the value of holdings by penalising them in advance for the occurrence of a very unlikely event and increasing the cost of capital for such entities. In turn this will disincentivise investments and risk further improvements in the CCP's risk management processes. Moreover, the potential for CCP shareholders to exercise claims against the resolution authority is minimised, as the counterfactual would in any major jurisdiction include the write-down of the CCP shareholder's equity under normal insolvency proceedings.

Full or partial write down of equity or cancel the existing shares/Dilution of existing shares

We agree that RAs should have the power to fully or partially write down equity or cancel existing shares. Mechanisms for adjusting the treatment of CCP equity in resolution should not however lead to (i) CCPs funding membership's trading losses or (ii) expose CCP's operational capital to losses.

Dilution of existing ownership by raising new capital through conversion or issuance of new shares.

Taking into consideration the distinction between operating capital and dilution of existing ownership as clarified in the previous paragraph, we believe that compensating CMs with instruments of ownership in return for a RA cash call or VMGH is not appropriate as it makes (i) the sale of the CCP more difficult (ii) weakens CM's incentives in the Recovery phase and (iii) threatens the independence of the CCP post-resolution (undermining G20 successful efforts in securing the appropriate level of independence for CCPs' risk management). Although we believe that both RA's cash calls and VMGH (under a predefined framework) should be available options that a RA could use in Resolution, these types of powers should only intend to provide authorities with the necessary resources required in Resolution and not to compensate members. Furthermore, we believe that in order to protect RAs for future claims RA tools such as cash calls and VMGH should be included in the CCP's Rulebook under the NCWOL counterfactual. However, those RA cash calls and potential use of VMGH should be clearly identified as additional tools intended to be used by RAs and not replace tools already existing in the CCP rulebook.

Any mechanism for compensation should fulfil three main objectives: (i) the preservation of the right incentives pre-resolution; (ii) the support for continuity and (iii) the preservation of the CCP's independence post-resolution.

15. Within the section on implementing policy for the treatment of CCP equity in resolution, are there additional items that the relevant home authorities should consider?

LSEG does not believe that there is a need to adjust the exposure of equity bearing loss in resolution and that an automatic trigger imposing DL on equity in addition to the SITG would directly affect CMs incentives to support recovery and avoid resolution. Besides, the value of a CCP's equity would be immediately impacted if a new resolution regime was to be introduced whereby shareholders were exposed to the possibility of equity dilution. This could easily make returns on equity unattractive.

The same problem would apply to future shareholders and effectively discourage private sector funding of CCPs leaving the Government (i.e. taxpayer) as the sole provider of funds, which, of course, is that any CCP R&R framework tries to avoid in the first place.

Any exposure of equity bearing loss in resolution should be decided on a case-by-case basis by the RA, especially where residual losses are being borne by the clearing community (CCP via the STIG, CMs,

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clients) following the placement into default of several CMs (e.g. when acting under the BRRD framework) or due to multiple CMs not meeting their contractual obligations.

LSEG believes imposing additional default losses on equity before resolution would fundamentally disincentivise CMs participation in recovery measures. The clearing community has contractually committed to a degree of losses through the CCP's rules and arrangements. Their legal obligations, as defined in CCP's Rulebook, prevents them from claiming any compensation when their losses are in line with their contractual obligations.

The NCWOL counterfactual is a crucial feature of a well-functioning CCP resolution regime, as it strikes the right balance between RAs legal protection from claims and the clearing community's incentives to participate in the recovery and resolution of a CCP. We believe that it is important that the counterfactual assumes at least '*the liquidation of the CCP in accordance with the applicable insolvency laws, assuming a full tear up of contracts at the time of resolution, and full application of loss absorbing financial resources, under the CCP's rules and arrangements and any other contractual agreements in accordance with the applicable insolvency law*' as described in FSB's 'Guidance on Central Counterparty Resolution and Resolution Planning'[8].

As stated above, when CMs commit to certain losses through the CCP's rules and arrangements, they should not be entitled to claim any compensation when their losses are in line with their predefined liabilities. This is the case when recovery tools included in the CCPs rules and arrangements are triggered by the CCP or by the RA. This provides legal certainty for the RAs, as well as transparency and predictability for CMs. Likewise, we support additional clarity and transparency in the powers included in the counterfactual.

Regarding potential implications on clients and to the continuity of critical services, we believe that the counterfactual for the NCWOL should encompass the perceived value of CMs and their clients to the continuation of the CCP. The counterfactual of NCWOL for DLs should consider the principle of 'value of continuity'/financial stability and should take into account the following:

- The CCP's default waterfall;
- The CCP's recovery tools, and
- The losses and costs of closing the CCP.

Losses resulting from the above, for which some are clearly defined (i.e. default waterfall and the recovery tools) will need to be added to the losses and costs of closing a CCP. Those losses can be derived from the existing costs of clearing plus an add-on cost to account for the CCP's replacement costs.

Applying those calculations would enable to demonstrate to stakeholders (including shareholders) the value vs costs of continuity which will provide them the necessary transparency in advance. On the contrary, a narrower approach to determining counterfactual, would expose RAs to ex-post financial claims if resolution tools were to be used beyond those contractually agreed between the CCP and CMs.

Ultimately, we believe that this approach would:

- Allow for legal certainty for the RA to focus on promoting financial stability by employing all relevant resolution tools without being inappropriately constrained by concerns around legal claims.
- Maintain the incentives of national regulations, such as EMIR, with regards to compensating a CM in resolution which will disincentive the CM to participate fully in the recovery actions of the CCP
- Provide transparency and clarity for CMs to measure the extent of their risks and have the right safeguards in place

[8] Guidance on Central Counterparty Resolution and Resolution Planning 5 July 2017, http://www.fsb.org/2017/07/guidance-on-central-counterparty-resolution-and-resolution-planning-2/

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16. Would a statement in the resolvability assessment process on any limitations to equity bearing losses provide sufficient transparency for stakeholders? How could sufficient transparency be achieved?

LSEG believes that regulatory frameworks of major jurisdictions provide sufficient transparency for all stakeholders in the assessment of limitations to equity bearing losses. Those limitations are well-understood and have traditionally been accepted by all market participants active on either national or a cross-border level and have consistently created an environment that supports cross-border activity in the clearing industry while enhancing financial stability. As such, we do not believe that additional statements in the resolvability assessment process is needed.

We hope that you will find LSEG's input provided in this consultation paper useful and we remain at your disposal for any additional clarifications.

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